Non-Recourse Loans

When 'No Personal Liability' Still Comes With Risk

Understanding Recourse vs. Non-Recourse Loans

In commercial transactions, loans are either recourse (the lender can recover against all of the borrower's assets in the event of default with personal liability) or non-recourse (recovery is limited to the assets pledged to secure the loan with no personal liability). Non-recourse loans, however, are rarely fully non-recourse and usually require limited guaranties or indemnities from the borrower and identified guarantors for certain specified events.

Common "Bad Boy" Carveouts in Non-Recourse Loans

A non-recourse carveout guaranty (a/k/a carveout indemnity) is typically limited to losses, damages, liabilities, costs or expenses which the lender may suffer due to the occurrence of certain specified events commonly known as "bad boy carveouts", including: (i) failure to perform obligations to prevent waste or to keep the property free of hazardous waste, (ii) failure to obtain and maintain insurance coverage, (iii) fraud or misrepresentations made by the borrower or guarantors, (iv) misappropriation or conversion of the security for the loan, (v) collection of revenue from the property in contravention of the terms of the loan documents or failure to apply revenue as required by the loan documents, or (vi) any act or omission resulting in termination of a credit lease or any offset or reduction of sums payable pursuant to a credit lease.

Grant Dobson

When Carveouts Can Become Full Liability

While commercial borrowers may be familiar with these type of carveouts to a non-recourse loan, what may come as a surprise are events that can cause the non-recourse carveout guaranty to convert to a partial or full guaranty of the loan, including (i) the borrower or guarantors filing, soliciting, consenting to, acquiescing or colluding in any voluntary or involuntary bankruptcy proceeding, (ii) obtaining subordinate financing, or (iii) failure to maintain the borrower's status as a single purpose entity. Other converting events can be unique to the type of loan or the type of collateral securing the non-recourse loan, such as loss of licenses and approvals or a change of management if the collateral is a senior care facility, or a failure to pay full principal and interest payments for a specified period of time at the commencement of the loan term. Another event a lender may seek to include is any fraud, material or intentional misrepresentations, gross negligence or willful misconduct by a "Related Party." This event is one that should more properly be a non-course carveout rather than a cause for full liability. Additionally, it is important that the term "Related Party" be limited and avoid including members, officers, agents or employees of the borrower.

When a Loan Starts With Full Guaranty Exposure

In some non-recourse loans, a lender may require a full guaranty of the loan commencing with the closing of the loan and continuing until the occurrence of certain events before converting to a non-recourse carveout guaranty. These events could include completion of construction or renovations of improvements if the loan proceeds are to be used for such purposes, achieving and maintaining a required occupancy percentage for a retail or office project or commencement of rent payments by a credit tenant.

Trigger Events That Can Revive Guaranty Obligations

Additionally, a borrower and guarantors may be required to provide a partial or full guaranty of the loan but the lender agrees only to enforce the guaranty upon the occurrence and continuance of a "trigger event", such as the expiration without renewal or termination of a credit lease without replacement by another acceptable credit lease. This type of guaranty can continue throughout the term of the loan and arise each time the trigger event occurs and continues.

Plan Early to Limit Liability Exposure

Properly documenting the terms and scope of any required non-recourse carveouts or guaranties for a non-recourse loan during the negotiation of the loan terms will avoid contentious negotiations later when the loan documents are presented for review. Be prepared to discuss this issue early with potential lenders to understand the liability exposure.

About the Author:

Grant Dobson, a Miller & Martin attorney with more than 35 years of experience, concentrates his practice in the areas of real estate development, construction and finance, and commercial finance and lending. He handles loan transactions for a national insurance company and represents real estate developers and operators in connection with the development, operation and financing of retail, office, residential, mixed-use developments and other commercial projects throughout the country. Grant also represents national and regional companies in connection with zoning issues, real property taxes matters and other matters involving state and local government regulation.